The Retirement Security Project

Retirement Saving for Middle- and Lower-Income Households: The Pension Protection Act of 2006 and the Unfinished Agenda

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The Retirement Security Project

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Summary

The proposition that public policies can and should be used to encourage retirement saving among middle- and lower-income households commands broad, bi-partisan support. Perhaps the most promising recent development in this area has been the rise of the automatic 401(k). Plan sponsors and policy makers are increasingly interested in using automatic or "opt out" 401(k)s to promote retirement security among rank-and-file employees. Because these workers also need meaningful financial incentives to save, the Saver's Credit, which interacts constructively with automatic 401(k) features, is specifically targeted to help them.

The Pension Protection Act of 2006 (PPA) took significant steps to encourage the use of automatic 401(k)s and the Saver's Credit. However, much remains to be done. This policy brief describes the automatic 401(k) and the Saver's Credit, assesses the effects of the recent legislation, and outlines the next steps needed to promote retirement saving for middle- and lower-income workers, focusing on four initiatives:

- Fulfilling the potential and expanding the implementation of the automatic 401(k);
- Creating automatic IRAs for the 75 million workers who have no employer retirement plan;
- Expanding the Saver's Credit, making it refundable, and converting the credit to a flat-rate match; and
- Changing current rules that penalize saving by limiting eligibility for government programs based on 401(k) or IRA savings.

"There's quite a debate among economists about how best to increase those saving rates. I'll just point to one direction that was included in the recent pension bill that the Congress passed and the President signed, which is to allow opt-out 401(k) programs among employers.

We have a lot of evidence that people — if they're required to opt out of a savings program, that the inertia will win out, and they'll save more. And that's really one of the ways in which we probably could increase saving at the private level."

-The Honorable Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System before the Committee on the Budget, U.S. House of Representatives, February 28, 2007

Automatic 401(k)

Over the past 25 years, private pension plans in the United States have tended toward a do-it-yourself approach in which eligible workers are required to take the initiative to save, bear more investment risk, and make more of their own decisions about their retirement saving. Some workers have thrived under this more individualized approach, but for many, the 401(k) revolution has fallen short of its potential. Work, family, and other more immediate demands often distract workers from the need to save and invest for the future. Those who do take the time to consider their choices may find the decisions complex: financial planning is seldom a simple task. For many, the result is poor decision making at each stage of the retirement savings process, putting both the level and the security of their retirement income at risk. Even worse, many people simply procrastinate when faced with difficult choices, and avoid dealing with the issues altogether, thereby dramatically increasing their risk of being financially unprepared for retirement.

"The automatic 401(k) is designed to improve retirement security for millions of workers without requiring them to become financial experts."

The automatic 401(k) is designed to improve retirement security for millions of workers without requiring them to become financial experts. In a nutshell, the automatic 401(k) harnesses the power of inertia by setting the default option at each phase of the 401(k) saving cycle to make sound saving and investment decisions the norm, even when the employee never gets around to making an explicit choice.[1]

By contrast, traditional 401(k) plans do not cover workers unless they actively sign up. Employees can participate only if they take the initiative to complete an enrollment form that requires them to decide whether to participate, how much to contribute, and how to invest. The result: about 1 in 4 eligible employees "leave money on the table" and fails to participate even when offered valuable employer matching contributions and tax advantages for contributing.

Under automatic enrollment, eligible employees participate unless they actively choose not to. The automatic 401(k) uses the same "default" approach to help employees increase their contribution level gradually over time, invest prudently, and preserve benefits for retirement through rollovers at the time of job change - all without putting the onus on individuals to take the initiative for any of these steps. At the same time, workers remain free to override the default options by choosing whether and how much to contribute and by controlling how their savings are invested. However, those who fail to exercise the initiative are not left behind.

Example:

A newly hired employee is automatically enrolled in her employer's 401(k) plan at a contribution rate of 4 percent of pay. Contributions are automatically invested in a sensibly-priced, professionally-managed account or life-cycle fund. The following year, the 4 percent contribution level automatically escalates to 5 percent of pay, continuing to escalate at 1 percent a year up to 12 percent. The employee may depart from any of these automatic or default arrangements at any time, opting out of the plan or into a different contribution level or different investment options. When the employee leaves her job, the account balance is automatically rolled over to an IRA owned by the employee, or automatically retained in the former employer's plan - unless the employee chooses otherwise.

A number of findings suggest the potential of automatic 401(k)s to increase retirement saving:[2]

- *Automatic enrollment* has been shown to raise 401(k) participation rates dramatically when it is applied to new hires, especially to new hires who are female, members of minority groups, and/or low-earners (Figure 1).[3] Automatic enrollment often cuts nonparticipation rates from roughly 25 percent to as little as 5 or 10 percent of newly eligible employees.

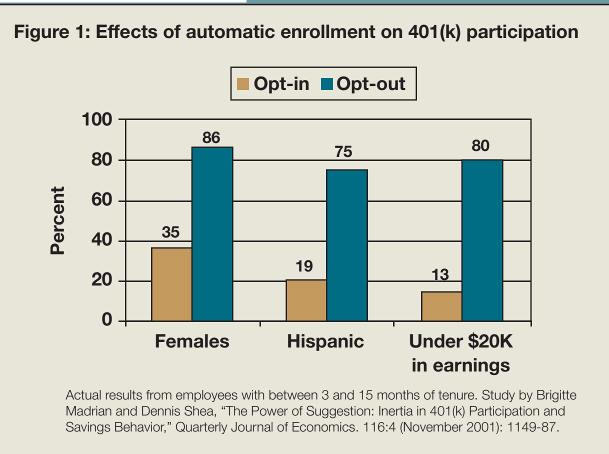
- *Automatic escalation* of contributions over time can raise overall contributions to 401(k)s as employees become accustomed to deferring receipt of a portion of their pay. Escalation also helps ensure that inertia does not keep some employees at a default contribution rate lower than the rate they would have chosen, absent the default.[4]

- *Automatic investment* can direct assets into balanced, prudently diversified, and low-cost vehicles and can help discourage overconcentration in employer stock in money-market or stable value assets.[5]

- *Automatic rollover* can help participants retain previously accumulated retirement savings in the tax-favored retirement system when they change jobs.[6]

Plan sponsors have an incentive to use automatic enrollment and escalation insofar as they help employees save and tend to improve plans' performance on the 401(k) nondiscrimination tests. Under these tests, the greater the average contributions by the majority of eligible employees, the more the executives and owners can contribute.

Figure 1: Effects of automatic enrollment on 401(k) participation



Actual results from employees with between 3 and 15 months of tenure. Study by Brigitte Madrian and Dennis Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," Quarterly Journal of Economics. 116:4 (November 2001): 1149-87.

Why Employers Use Automatic Enrollment: The Business Case

Sponsors of 401(k) plans are increasingly adopting automatic enrollment and other automatic features, and surveys suggest the vast majority of employers that have used automatic enrollment have been satisfied with it.[7]

1. Recruiting and Retaining Valued Employees By Providing Plans That Work

Automatic enrollment and escalation, together with appropriate default investments, tend to make 401(k) plans more effective in recruiting and retaining valuable employees. Accordingly, many plan sponsors no longer simply offer employees the opportunity to save. Companies sponsoring 401(k) plans are increasingly viewing automatic features as "the right thing to do" to help employees save.

2. Improving Nondiscrimination Results

By raising participation and/or contribution rates among middle- and lower-income workers, automatic enrollment and escalation tend to produce better performance under the nondiscrimination standards.[8] By comparing the average contribution percentage for highly paid and non-highly paid employees, the nondiscrimination standards link executives' ability to enjoy larger tax-preferred benefits to the employer's success in encouraging or providing greater benefits for most employees. In addition, beginning in 2008, plans opting to meet the conditions of a new PPA nondiscrimination safe harbor can avoid nondiscrimination and "top heavy" testing altogether.

3. Mitigating the Loss of Defined Benefit Pensions ("DBs")

When plan sponsors have frozen or cut back DBs, some have upgraded their 401(k)s through automatic features, seeking to mitigate somewhat the employees' loss of future DB benefits. By sparing employees the need to take the initiative to enroll and by simplifying their decision-making process (especially through appropriate default investments), automatic 401(k) features can replicate or approximate some valuable DB attributes, such as automatic coverage and professional investment management.

Automatic Escalation

Automatic escalation makes automatic enrollment more effective by gradually increasing employees' contribution levels over time, unless and until employees opt out of the increase. Automatic enrollment also helps employees save by getting them into the plan; automatic escalation gives them a better chance of achieving adequate contribution levels. Escalation also helps employers do better on the 401(k) nondiscrimination tests and helps counteract the possible "drag down" effect whereby automatic enrollment at a relatively low contribution level might induce some employees, who go with the default, to contribute less than they otherwise would have contributed.

Escalation could be fully automatic from the outset, so that all participants' contribution rates automatically increase by a specified amount (such as one or two percentage points) each year unless and until they opt out. (For example, new hires are automatically enrolled at 3 percent; employees in their second year at 4 percent; in their third year at 5 percent, etc.) Alternatively, participants can be offered a one-time opportunity to elect annual escalation, so that the default is no escalation, but once elected, escalation continues automatically unless and until they opt out.

Increases in contribution rates could coincide with wage increases or raises (so employees never experience a decline in take home pay)[9] or could occur on a fixed date, such as the first day of the year or the anniversary of an employee's date of hire.[10] Escalation has been made a condition of the PPA 401(k) automatic enrollment safe harbor.

Automatic 401(k) and the Pension Protection Act of 2006

The Pension Protection Act of 2006 seeks to encourage 401(k) plan sponsors to adopt automatic features by addressing three significant concerns that have held many employers back and by attempting to provide a new incentive.[11]

Preemption of State Laws

Some firms considering automatic enrollment have been concerned that automatic payroll deductions might be prohibited by state anti-garnishment laws, which require an employee's explicit written authorization in order to prevent inappropriate and involuntary deductions from employee pay. The PPA provides that federal law preempts such state laws to the extent necessary to allow employers in all 50 states to automatically deduct 401(k) and similar retirement saving contributions from employees' paychecks.

"Unwind" of Automatic Enrollment

Another concern of plan administrators has been the risk that new, automatically enrolled participants might demand a refund of their automatic contributions, claiming they did not read or understand the advance notice, and that 401(k) withdrawal restrictions would prevent the plan from honoring such requests. Moreover, even if refunds were permitted, they would ordinarily be subject to a 10 percent early withdrawal tax. The PPA addressed this concern by providing flexibility through a retroactive "unwind" provision; beginning in 2008, 401(k), 403(b) and 457 plans will be allowed to return the full amount of automatic contributions without the 10 percent tax if an employee so requests within 90 days after the contributions begin.

Fiduciary Relief for Specified Default Investments

Plan sponsors are protected to some degree from fiduciary liability for the consequences of investments elected by employees. However, until the PPA, this protection for "self-directed" investments did not extend to investments that employees "chose" by default (i.e., without making an explicit election), as in the case of automatic enrollment. For many employers considering automatic enrollment, this was a concern, which the PPA has now addressed. The PPA directs the Department of Labor to issue regulations specifying certain default

investments that allow employers the same protection from fiduciary liability that they currently enjoy for employee-elected investments. This fiduciary protection is not total: plan fiduciaries still must be prudent in selecting the investment options on the menu they offer employees, while avoiding conflicts of interest and excessive fees.

In September 2006, proposed Labor Department regulations specified three types of default investments that entail asset allocation and that would qualify for this fiduciary protection.[12] These are life cycle or target maturity funds, balanced funds consisting of equities and fixed income investments, and professionally managed accounts. Final regulations are expected this year.

New Nondiscrimination Safe Harbors for Automatic Enrollment Plans

In addition to removing barriers, the PPA attempts to provide a new incentive to use automatic enrollment. As noted, 401(k) nondiscrimination standards seek to align management's interests with the interests of average employees and taxpayers who fund tax subsidies for 401(k) plans. These standards link executives' ability to enjoy larger tax-preferred benefits to the employer's success in encouraging or providing greater benefits for the majority of employees.

The PPA provides a new exemption from the 401(k) nondiscrimination standards that breaks and even reverses the linkage of interests between management and workers. Beginning in 2008, a plan will be exempt from the nondiscrimination (including the "top heavy") standards if it applies automatic enrollment to new hires (and to existing nonparticipating employees who did not explicitly opt out) at 3 percent of pay (at least), escalating 1 percent a year up to at least 6 percent. Among other requirements, the plan must also offer specified employer matching contributions (conditioned on employee contributions) or make non-matching contributions that, in either case, vest after 2 years.

This new exemption, however, is probably unnecessary and could even prove counterproductive. Although it provides a reminder that automatic escalation is permitted and desirable, the exemption as a whole could unfortunately remove an employer's financial incentive to encourage its lower-income employees to save. An employer exempted from compliance with the nondiscrimination standards not only loses its financial incentive to encourage participation but could actually acquire a financial incentive to discourage participation: the more employees save, the greater the matching contribution costs incurred by the employer without any countervailing benefit in the form of improved nondiscrimination testing. There is no evidence regarding the effectiveness of automatic enrollment when administered by an employer with a financial incentive to minimize participation, i.e., in circumstances where greater participation increases the employer's matching costs without any compensating improvement in nondiscrimination results. An employer that administered automatic enrollment in a way that actually encouraged employees to opt out would be merely offering, not making, matching contributions.

Despite its questionable design, is it possible that, on balance, this new exemption will do more good than harm? Certainly. Experience will tell whether it ultimately advances retirement security, sets it back, or has no significant effect.

Automatic 401(k): Building Second Generation Plans

In the wake of the PPA, much still remains to be done in Congress, the Executive Branch, and the market to expand and improve the automatic 401(k).

Plans that use automatic features need further encouragement to evolve from what we call "first generation" to "second generation" automatic features. A "first generation" automatic 401(k) might typically automatically enroll only new hires at a 3 percent contribution rate, without escalation. Investments would be in a stable value or money market fund. A "second generation" automatic 401(k) improves on each of these default choices. It would automatically enroll both new hires and existing nonparticipating employees at a 5 or 6 percent automatic contribution, escalating automatically up to a significantly higher level. Assets would be invested automatically (i.e., by default) in a low-cost professionally managed account or life cycle fund.

Initial Default Contribution Rates

More than 75 percent of plans with automatic enrollment have a default contribution rate of only 3 percent or less, which is less than half of the average pre-tax contribution rate of about 7 percent of pay.[13] Research has indicated that automatic enrollment can induce some employees to passively maintain the default contribution rate over time, including employees who might otherwise have elected to contribute at a higher rate[14] and employees who would otherwise contribute less but could be induced by a higher default rate to contribute more. Setting and adhering to a very low default contribution rate can therefore significantly limit the power of the automatic 401(k) to increase retirement saving.

If automatic enrollment is to realize its full potential to increase saving, default contribution rates need to be substantially higher. A number of plans reportedly have moved to an initial default contribution rate of 5 or 6 percent of pay, and have found that participant opt-out rates at these levels were not much higher than at 3 percent of pay.

Automatic Enrollment of Existing Employees (Not Only New Hires)

Most plan sponsors have applied automatic enrollment to newly hired employees only. However, increasing numbers of employers are extending automatic enrollment to existing employees who have not been participating in the 401(k) plan.[15] Typically, these are people who did not make a written election to stay out of the plan but often failed to join because of inertia or procrastination. Employers can communicate with these employees regarding the advantages of participation and inform them that they will be automatically enrolled unless they opt out. Automatic enrollment could be extended to these nonparticipants once or periodically (say, every two or three years).

	First Generation Automatic 401(k)	Second Generation Automatic 401(k)
Initial contribution rate	3%	5-6%
Escalation of contributions?	No	Annually, up to at least the match limit or higher (e.g. 10%, 12%)
Investment allocation	Stable-value	Managed account, life-cycle, or life-style (balanced) fund
Apply Auto 401(k) to	New hires	All covered nonparticipating employees
Plan Size	Large	All sizes

Automatic Escalation

As discussed earlier, for automatic enrollment to realize its potential, default contribution rates also need to increase over time for employees who continue to participate; and if the plan starts with a low default contribution rate, it becomes even more important to raise that rate for continuing participants. Thus far, few plans (an estimated 15 percent of those that use automatic enrollment) have implemented such automatic escalation.[16] However, it appears that plan sponsors are increasingly considering this important technique.[17]

Automatic Investment

Labor Department regulations issued pursuant to the PPA should appropriately accommodate default investments that preserve principal (used by numerous plan sponsors that have adopted automatic enrollment), at least in the short term (for example, where a principal-preserving default automatically converts after a year or two to asset-allocated investments). In addition, the regulations' definitions of qualifying default investment alternatives might usefully be made more flexible in order to accommodate creative new investment products (such as life cycle or balanced funds that include guarantees or other elements of principal preservation). The regulations also should give greater emphasis to the need for cost control in default investments, especially through the use of index funds or similar arrangements.[18]

In addition, the PPA did too little to discourage the over-concentration in employer stock that exposes participants to unnecessary risk. While there is a fine line to walk because matching employee saving with employer stock is better than no employer match at all, plan participants can be better protected from the risk that their employer's failure or financial difficulties will cost them both their jobs and their retirement savings.

First, with policies that continue to encourage asset-allocated default investments (such as professionally managed accounts or life cycle funds), over-concentration in employer stock should eventually give way to better asset allocation. Second, employers that recognize their employees are over-exposed to company stock often fear that diversification could expose them to fiduciary liability or employee criticism if the stock price rises, could signal lack of confidence in the future of the enterprise, and, in some cases, could depress the market for the company's stock. Congress could address most of these concerns by giving fiduciary protection to plan sponsors that follow a safe harbor "glide path" systematically and gradually diversifying participants' investments in company stock. Third, Congress could consider stronger measures that might require plans to (i) offer employees asset-allocated investment options, (ii) offer employees the option to diversify out of employer stock on a "dollar cost averaging" basis, or even (iii) gradually diversify employees out of employer stock, as Congress did in the 1970s and 1980s by imposing a 10 percent limit on employer stock in defined benefit pension plans. Finally, Congress should remedy the PPA's failure to strengthen and rationalize the antiquated and ineffective diversification requirements applicable to employee stock ownership plans (ESOPs), tax-qualified retirement plans or employer contributions designed to be primarily invested in employer stock.

Automatic rollover and annuitization

Further work is also needed to determine how best to improve the 401(k) distribution phase by promoting both rollovers (to reduce the risk that retirement savings will be dissipated)[19] and annuitization (to reduce the risk of outliving one's retirement savings). Specifically, efforts are under way

to explore means of expanding low-cost annuity options and promoting the appropriate use of longevity insurance and reasonably-priced, portable annuity income that accumulates over time.

Expand Automatic 401(k)s to Mid-Sized and Smaller Firms

Automatic 401(k)s have been expanding briskly. In 2005, over 34 percent of large 401(k) plans — those with 5,000 or more participants — used automatic enrollment, up from about 30 percent the year before and from virtually zero ten years ago.[20] However, to date, automatic features have not caught on to any similar extent among mid-sized and small 401(k) plans. Based on recent surveys, roughly 14 percent of firms with fewer than 5,000 participants have been using automatic enrollment.[21] Accordingly, to increase 401(k) participation among eligible nonparticipating employees, automatic 401(k)s not only need to continue spreading among larger plan sponsors but also need to make more significant inroads into the mid-sized and smaller employer market.

Continue Clarifying the Role of Federal Policies

The legislative preemption of state laws is unfortunately conditioned on the automatic enrollment involving default investments described in Labor Department regulations. Automatic enrollment should be permitted without regard to state anti-garnishment laws and without regard to whether a plan uses specified default investments.

Congress and the states, as appropriate, should also make clear that state anti-garnishment laws do not preclude automatic enrollment in retirement savings plans such as Section 403(b) tax-sheltered annuities and Section 457 plans that are sponsored by States or nonprofit organizations. Many of these plans (as well as the Thrift Savings Plan covering federal government employees) could use automatic enrollment, but at present, virtually none do. In addition, Treasury should make clear that plans using the automatic enrollment nondiscrimination safe harbor should be free to escalate contribution rates to a level higher than 6 percent of pay, which is below the current average 401(k) contribution rate, and in fact higher than 10 percent of pay.

Saver's Credit

Automatic features in 401(k) plans make participation easier, but effective financial incentives are also necessary. Federal tax preferences for retirement saving are quite costly, exceeding $100 billion per year. These subsidies, however, take the form of income tax deductions or exclusions, which deliver tax savings in proportion to one's marginal tax rate. This is an "upside down" structure because it provides minimal incentives to the majority of American households (those who are in the 15%, 10% or zero income tax brackets and who most need to save more to provide for basic needs in retirement) while reserving the largest incentives for the highest-income households. Moreover, as a strategy for promoting national saving, these subsidies are poorly targeted because higher-income taxpayers are disproportionately likely to respond not by increasing actual saving, but by simply shifting existing assets from taxable to tax-preferred accounts.

The Saver's Credit, enacted in 2001, was designed to address these problems.[22] As the only major pension tax incentive targeted specifically to the majority of American households, it was designed to level the playing field by giving taxpayers earning less than $50,000 a tax credit for contributions to 401(k) plans, IRAs, and similar retirement savings vehicles. Although it was originally proposed as a permanent, 50% refundable tax credit, Congress sought to save revenue for other purposes by enacting the Saver's Credit as a nonrefundable credit with three income-based rates (only 10 percent for most of those eligible) and a 2006 sunset date.

The PPA has begun to restore the Saver's Credit to its intended design by making it permanent and indexing its income eligibility limits to inflation. However, the PPA leaves undone four major needed improvements to the Saver's Credit.

First, because the Saver's Credit is nonrefundable, it merely offsets a taxpayer's tax liability; it provides no saving incentive for some 50 million lower-income households that have no income tax liability. Making the Saver's Credit refundable would provide an important incentive to these households to save regularly and continually. It would also help secure the retirement of those with the lowest incomes, thus making them less dependent on Social Security income and means-tested government programs during their retirement years.

Second, the credit might have an enhanced incentive effect - and refundability might be more palatable to a bipartisan majority of Congress - if it took the form of an explicit government matching deposit to the contributor's IRA or 401(k) account rather than the current implicit match.[23]

Third, with 10, 20, and 50 percent credit rates and eligibility for each varying with income, the Saver's Credit is overly complicated and has inefficient "cliffs" at several income levels. It should be restored to its original design of a single, simple 50 percent credit, phased out smoothly above the income eligibility limit.

Fourth, the Saver's Credit still does not level the playing field for enough middle-income American families. Millions of households get little incentive from tax deductions because they are in the 15 percent income tax bracket, yet are ineligible for the Saver's Credit because they earn more than $50,000. A limit of about $70,000 per year would cover roughly those in the 15 percent or lower tax brackets, helping middle-class Americans save for a secure retirement.

Automatic IRA

The major unfinished business of the PPA is expanding coverage. Except by slightly improving the Saver's Credit, the legislation does not attempt to extend retirement savings coverage to workers who have no access to an employer-provided retirement plan. These workers currently number about 75 million, or about half of the U.S. work force.[24] The Retirement Security Project and the Heritage Foundation have jointly proposed to build on the success of employer plans and the automatic 401(k) to extend payroll deposit savings to most of the 75 million through the proposed "automatic IRA."[25]

Under this proposal, which has been introduced as legislation on a bipartisan basis,[26] a firm that is not ready to adopt a 401(k) or other retirement plan would offer its employees the ability to contribute to an IRA every payday by payroll deposit, much as millions of employees have their paychecks deposited directly to their bank accounts. It is easier to save small amounts on a regular basis; and once payroll deposits begin, they continue automatically unless the worker later opts out. Employers above a certain size (e.g., ten employees) that have been in business for at least two years but that still do not sponsor any plan for their employees would be required to offer employees this payroll-deduction saving opportunity.

The automatic IRA would involve no contributions or other outlays by employers, who would merely offer their payroll system as a conduit that employees could use to save part of their own wages in an IRA. Participating employers would receive temporary tax credits, would be required to obtain a written waiver from any employee who does not participate, would be encouraged to use automatic enrollment,

and would be able to protect themselves from fiduciary liability. Employees, or the employer, could designate the IRA to receive the savings, including, as a fallback for those unable or unwilling to choose, a national platform IRA that could be based on the federal employees' Thrift Savings Plan accounts. The default investment would be a diversified, low-cost life cycle fund, with other choices available.[27] The self-employed would be encouraged to save by extending payroll deposit to independent contractors, facilitating direct deposit of income tax refunds, and expanding access to automatic debit arrangements linked to IRAs, including on-line and traditional means of access through professional and trade associations.

Asset Tests

While automatic 401(k)s and an improved Saver's Credit encourage retirement saving, outdated asset tests in means-tested public assistance programs penalize lower- and moderate-income households that respond by saving.[28] Many low- and moderate-income families rely in times of need on public assistance programs such as Food Stamps, Temporary Assistance for Needy Families (TANF), Medicaid, and Supplemental Security Income. To be eligible, applicants generally must meet an asset test as well as an income test. While the asset tests usually do not count accrued benefits under a defined benefit plan as assets, too often they do count 401(k) or IRA balances or both. This has the effect of a steep implicit tax on 401(k) and IRA saving. As a result, families with incomes low enough to qualify for a means-tested program under the income test might respond by saving less.

Also, while some state programs have eliminated asset tests, or at least aligned the treatment of defined contribution plans with that of defined benefit plans, many have not. Asset tests treat retirement saving in a confusing and seemingly arbitrary manner, with different restrictions state-by-state and account-by-account. Congress and the states should therefore eliminate this implicit tax on retirement saving by mandating that retirement accounts such as 401(k)s and IRAs be disregarded for eligibility and benefit determinations in federal and state means-tested programs. Changing the law to exempt retirement accounts from being considered in means-tested programs would treat retirement savings fairly and consistently and would send an important signal to families that rely or might need to rely on means-tested programs in the future: you will not be penalized for saving for retirement.

Eliminating asset rules for retirement savings will have some short-term costs as additional lower-income households will qualify for and use means-tested benefit programs. However, these costs should be modest; and if moderate- and low-income households can save for a more secure retirement, fewer people will have to rely on public benefits in old age.

Conclusion

The Pension Protection Act of 2006 has taken significant steps to encourage the use of automatic 401(k) features and to consolidate the Saver's Credit. However, further legislative, regulatory, and corporate action is needed to make saving easier by expanding the use of the automatic 401(k), by improving the Saver's Credit, and by reforming the asset tests that currently penalize saving by those otherwise eligible for public assistance. Finally, Congress needs to complete the major unfinished business of the PPA and expand coverage to the half of the work force that lacks access to any employer plan by instituting automatic, universal IRAs. Automatic IRAs will extend to tens of millions of workers the powerful mechanism of regular payroll deposit saving. Together, these measures comprise a comprehensive and effective strategy to expand retirement saving: a strategy that particularly benefits those working Americans who currently lack sufficient opportunities or incentives to save, and whose contributions are most likely to represent new savings.

In a written statement submitted to the Senate Special Committee on Aging, February 28, 2007, Comptroller General David M. Walker cited individual counseling services, automatic enrollment in retirement savings plans, and ongoing education to ensure balanced portfolios as effective ways to help employees save for retirement.

[1] See William G. Gale, J. Mark Iwry, and Peter R. Orszag, "The Automatic 401(k): A Simple Way to Strengthen Retirement Savings," (Retirement Security Project Policy Brief No. 2005-1, March 2005; available at www.retirementsecurityproject.org).

[2] See generally J. Mark Iwry, William G. Gale, and Peter R. Orszag, "The Potential Effects of Retirement Security Project Proposals on Private and National Savings: Exploratory Calculations," (Retirement Security Project Policy Brief No. 2006-2, November 2006; available at www.retirementsecurityproject.org), estimating that the automatic 401(k) could bring about a net increase of $44 billion a year in national saving.

[3] Brigitte Madrian and Dennis Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," Quarterly Journal of Economics 116, no. 4 (November 2001):1149-87; and James Choi and others, "Defined Contribution Pensions: Plan Rules, Participant Decisions, and the Path of Least Resistance," in Tax Policy and the Economy, Vol. 16, edited by James Poterba (MIT Press, 2002), pp. 67-113. Related approaches have also proven effective, but generally are less powerful. One such approach is to require employees to make an explicit election so that inertia does not prevent employees from participating or lead them to contribute less than they would if they were required to choose. Another approach presents employees with a presumptive contribution rate packaged together with an investment option - not as a default, but as an easy choice employees can make by checking a single box.

[4] Richard Thaler and Shlomo Benartzi, "Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving," Journal of Political Economy 112, no. 1, pt. 2 (2004), S164-S187.

[5] William G. Gale and J. Mark Iwry, "Automatic Investment: Improving 401(k) Portfolio Investment Choices," (Retirement Security Project Policy Brief No. 2005-4, May 2005; available at www.retirementsecurityproject.org); William G. Gale, J. Mark Iwry, Alicia H. Munnell, and Richard H. Thaler, "Improving 401(k) Investment Performance," (Center for Retirement Research Issue Brief No. 2004-26, December 2004; available at www.bc.edu/crr); and J. Mark Iwry, "Promoting 401(k) Security," (Urban-Brookings Tax Policy Center, September 2003; available at www.taxpolicycenter.org).

[6] William G. Gale and Michael Dworsky, "Effects of Public Policies on the Disposition of Lump-Sum Distributions: Rational and Behavioral Influences," (Center for Retirement Research Working Paper No. 2006-15, August 2006; available at www.bc.edu/crr).

[7] In the Deloitte 2005/06 Annual 401(k) Benchmarking Survey, 2006 (referred to below as "Deloitte 2005/06 Survey"), 96 percent of plan sponsors are satisfied with automatic enrollment.

[8] While most plan sponsors surveyed by the Deloitte 2005/06 Survey that use automatic enrollment said they adopted it to increase participation or encourage retirement saving, the survey reports that 21 percent of sponsors said that their primary motivation for adding automatic enrollment was to improve nondiscrimination test results.

[9] Under the "Save More Tomorrow" program proposed by Thaler and Benartzi, participants can agree that future pay increases will generate additional contributions.

[10] The IRS has explicitly approved both approaches in a general information letter addressed to one of the authors. IRS General Information Letter dated March 17, 2004 to J. Mark Iwry.

[11] The PPA, Public Law No. 109-280, was signed into law on August 17, 2006. This brief addresses only the PPA provisions relating to automatic features in 401(k) type plans, as opposed to the extensive PPA provisions relating to defined benefit plans and other pension issues. For further discussion of these PPA provisions, see. J. Mark Iwry, "Analysis of the Pension Protection Act of 2006: Increasing Participation Through the Automatic 401(k) and Saver's Credit" (Retirement Security Project, August 15, 2006).

[12] "Default Investment Alternatives Under Participant Directed Individual Account Plans; Proposed Rule," Department of Labor Employee Benefits Security Administration, Federal Register (Vol. 71, No. 187), September 27, 2006.

[13] Hewitt Associates, Trends and Experiences in 401(k) Plans 2005 survey (referred to below as "Hewitt Trends 2005 Survey") and the Profit Sharing/401(k) Council of America, PSCA's 49th Annual Survey of Profit Sharing and 401(k) Plans, 2006 (referred to below as "PSCA 49th Annual Survey").

[14] James Choi, David Laibson, Brigitte Madrian and Andrew Metrick, "For Better of For Worse: Default Effects and 401(k) Savings Behavior," in Perspectives in the Economics of Aging, edited by D. Wise (University of Chicago Press, 2003), pp. 81-121.

[15] Roughly 3 out of 4 plans targeted only new hires when they implemented automatic enrollment (72 percent in the Deloitte 2005/06 survey and 81 percent in the Hewitt Trends 2005 survey). According to Hewitt Associates' Hot Topics in Retirement 2007 survey of large plan sponsors, 55 percent of plan sponsors not currently offering automatic enrollment are "very likely" or "somewhat likely" to offer it for new hires in 2007. Only 26 percent indicate they will offer it to current nonparticipants as well.

[16] The PSCA 49th Annual Survey reports that 14.8 percent of plans with automatic enrollment also increase contribution rates over time. The Deloitte 2005/06 Survey asks about "step-up" programs and finds that 16 percent of plans have a separate, stand-alone step-up feature while only 2 percent of plans (or 9 percent of those with automatic enrollment) have a step-up feature tied to automatic enrollment.

[17] The Deloitte 2005/06 Survey reports that 20 percent of plan sponsors are considering implementing automatic escalation features.

[18] See letter from J. Mark Iwry, Principal, Retirement Security Project, to Department of Labor Employee Benefits Security Administration, dated November 13, 2006, commenting on the Department's proposed regulations (see note 13).

[19] Automatic rollover has the potentially valuable byproduct of increasing use of IRAs and promoting retirement saving among middle- and low-income families who might no longer have access to a 401(k)-type plan.

[20] PSCA 49th Annual Survey.

[21] Overall, 16.9 percent of plans in 2005 used automatic enrollment according to the PSCA 49th Annual Survey. The Deloitte 2005/06 Survey reported that 23 percent of all plans use automatic enrollment.

[22] J. Mark Iwry, William G. Gale, and Peter R. Orszag, "The Saver's Credit," (Retirement Security Project Policy Brief No. 2005-2, March 2005; available at www.retirementsecurityproject.org); and J. Mark Iwry, William G. Gale, and Peter R. Orszag, "The Saver's Credit: Issues and Options," (Tax Policy Center Tax Notes, May 3, 2004; available at www.taxpolicycenter.org).

[23] The explicit 50 percent credit is an implicit 100 percent match. For an example, consider a couple earning $30,000 who contributes $2,000 to a 401(k) plan. The Saver's Credit reduces that couple's federal income tax liability by $1,000 (50 percent of $2,000). The net result is a $2,000 account balance that costs the couple only $1,000 after taxes (the $2,000 contribution minus the $1,000 tax credit). This is the same result that would occur if the net after-tax contribution of $1,000 were matched at a 100 percent rate: the couple and the government each effectively contribute $1,000 to the account. While taxpayers should respond the same to equivalent implicit and explicit matches, empirical research provides evidence to the contrary. For a detailed discussion, see Esther Duflo, William Gale, Jeffrey Liebman, Peter Orszag, and Emmanuel Saez, "A New Government Matching Program for Retirement Saving," (Retirement Security Project, June 2005; available at www.retirementsecurityproject.org).

[24] Craig Copeland, "Employment-based Retirement Plan Participation: Geographic Differences and Trends, 2005" (Employee Benefit Research Institute Issue Brief No. 299, November 2006; available at www.ebri.org).

[25] See J. Mark Iwry and David C. John, "Pursuing Universal Retirement Security Through Automatic IRAs," (Retirement Security Project Policy Brief No. 2007-2, Forthcoming April 2007); J. Mark Iwry and David C. John, "Pursuing Universal Retirement Security Through Automatic IRAs," Testimony before the Senate Finance Committee, June 29, 2006. These and related publications are available at www.retirementsecurityproject.org.

[26] S. 3951, S. 3952, and H.R. 6210.

[27] For a detailed description of the automatic IRA, see J. Mark Iwry and David C. John, "Pursuing Universal Retirement Security Through Automatic IRAs," Testimony before the Senate Finance Committee, June 29, 2006.

[28] For a detailed discussion of this issue, see Zoë Neuberger, Robert Greenstein, and Eileen P. Sweeney, "Protecting Low-Income Families' Retirement Savings: How Retirement Accounts Are Treated in Means-Tested Programs and Steps to Remove Barriers to Retirement Saving," (Retirement Security Project Policy Brief No. 2005-6, June 2005; available at www.retirementsecurityproject.org).

Notes:

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Mission Statement

The Retirement Security Project is dedicated to promoting common sense solutions to improve the retirement income prospects of millions of American workers.

The goal of The Retirement Security Project is to work on a nonpartisan basis to make it easier and increase incentives for middle- and lower-income Americans to save for a financially secure retirement.

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